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In the Supreme Court of the United States

No. 416.

OCTOBER TERM, 1970.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

CHARLES W. and DOROTHY F. STEADMAN,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT.

BRIEF OF RESPONDENTS IN OPPOSITION.

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TABLE OF CONTENTS.

Question Presented	1
Statutes and Regulations	2
Statement of the Case	5
Argument	6
Conclusion	12

TABLE OF AUTHORITIES CITED.

Cases.

Berenyi v. District Director, Immigration Service, 385 U.S. 630	10
Booth Newspapers, Inc. v. U. S., 157 Ct. Cl. 886, 303 F.2d 916	11
Corn Products Co. v. Commissioner, 350 U.S. 46	6, 8, 10, 11
Graver Tank & Manufacturing Company, Inc. v. Linde Air Products Co., 336 U.S. 271	10
Journal Co. v. U. S., 195 Fed. Supp. 434	8
Layne & Bowler Corporation v. Western Well Works, 261 U.S. 387	10
Mansfield Journal Co. v. Commissioner, 274 F.2d 284	8
Rudolph v. U. S., 370 U.S. 269	10
Southern Power Co. v. No. Carolina Public Service Co., 263 U.S. 508	10
U. S. vs. Waterman, Largen & Co., Inc., 419 F.2d 845	6, 7, 8, 11
Western Wine & Liquor Co. v. Commission, 18 T.C. 1090	11

Statutes and Regulations.

Code of Federal Regulations, Title 26, Part 1:

Regulation 1.165-5 4, 7

Regulation 1.1221-1 4, 7

Internal Revenue Code of 1954 (26 U.S.C.):

Sec. 165 2

Sec. 1221 2, 7

Sec. 1234 8

Sec. 1242 9

Sec. 1244 9

Sec. 1246 9

Sec. 1248 9

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QUESTION PRESENTED.

1. Whether the Courts below correctly held that taxpayer's loss on the worthlessness of corporate stock acquired and held to preserve and to protect the legal business of the taxpayer was deductible as an ordinary business expense.

STATUTES AND REGULATIONS.

The Commissioner sets forth Sec. 1221 of the Internal Revenue Code of 1954 (26 U.S.C.) as the Statute involved herein. Also relevant are:

Internal Revenue Code of 1954 (26 U.S.C.):

Section 165, Losses.

Subsection (a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Subsection (b) Amount of Deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

Subsection (c) Limitation On Losses of Individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. A loss described in this paragraph shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100. For purposes of the $100. limitation of the preceding sentence, a husband and wife making a joint return under section 6013 for the taxable year in which the loss is allowed as a deduction shall be treated as one individual. No loss described in this paragraph shall be allowed if, at the time of filing the return, such loss has been

claimed for estate tax purposes in the estate tax return.

Subsection (g) Worthless Securities.—

(1) General Rule.—If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security Defined.—For purposes of this subsection, the term "security" means—

(A) a share of stock in a corporation;

(B) a right to subscribe for, or to receive, a share of stock in a corporation; or

(C) a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) Securities In Affiliated Corporation.—For purposes of paragraph (1), any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as capital asset.

For purposes of the preceding sentence, a corporation shall be treated as affiliated with the taxpayer only if—

(A) at least 95 percent of each class of its stock is owned directly by the taxpayer, and

(B) more than 90 percent of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities,

and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains therefrom.

Code of Federal Regulations, Title 26 Part 1:

Section 1.165-5. Worthless Securities.

Subsection (a) Definition of Security.

As used in Section 165 (g) and this section, the term "security" means

(1) A share of stock in a corporation;

(2) A right to subscribe for, or to receive, a share of stock in a corporation; or

(3) A bond, debenture, note or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

Subsection (b) Ordinary loss.

If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under Section 165 (a) as an ordinary loss.

Section 1.1221-1 Meaning of terms.

Subsection (a) The term "capital assets" includes all classes of property not specifically excluded by section 1221. In determining whether property is a "capital asset," the period for which held is immaterial.

STATEMENT OF THE CASE.

The Commissioner's statement of the facts in his Petition is essentially accurate. His statement that 38,000 shares of Richards Music stock were sold to outsiders is somewhat misleading. These shares were subscribed for by Respondent, issued to a stock brokerage firm, headed by a friend and associate of Respondent which was brought into the picture by Respondent, and the shares were held by said brokerage firm for itself and for friends of the head of the firm. The Commissioner's statement concerning the time of worthlessness (Petition, p. 5) is also misleading since the Courts below found as a fact that Respondent's stock became worthless in 1962, prior to the institution of the Chapter XI bankruptcy proceeding (Petition, App. A., p. 11).

What is missing from the Commissioner's statement of the case is a recitation of any sufficient facts or reasons to warrant a review by this Court on certiorari of the decision below.

This is not a case where the court of appeals has rendered a decision in conflict with that of another court of appeals, nor does it involve any important question of law that has not already been settled by this Court. Neither does it involve a decision on any federal question that conflicts with applicable decisions of this Court.

ARGUMENT.

The commissioner states under his heading "Reasons For Granting the Writ" (Petition, p. 5) that the issue involved in this case is essentially the same as in the case of *United States v. Waterman, Largen & Co., Inc.* and relies on the reasons stated in the petition for a writ of certiorari filed in this Court in that case in asking that the instant petition be granted.

The Commissioner does distinguish the *Waterman, Largen* case on the basis that in the instant case the respondent made no showing as to the extent of injury to his law practice that would have resulted from the loss of Richards Music as a client (Petition, p. 6). This statement is made in the face of the findings of the Court below that the value of the services rendered by respondent to this client during the years 1961 through 1964 totalled $144,615.50 and in the face of the Commissioner's own statement to the Court of Appeals that respondent purchased the stock in question in order to retain a client "affording substantial fees for legal services" (Petition, Appendix A, p. 14). It is surely obvious that the loss of a client producing an average of $36,000 of fees per year is injurious to any attorney's practice and that the dollars involved speak for themselves as to the extent of the injury.

The Commissioner then states (Petition, p. 6) that in his view a business purpose for the acquisition of corporate stock never results in such stock attaining the status of a noncapital asset. This viewpoint seems to ignore prior decisions of this Court, the Commissioner's own Regulations, and numerous lower courts' decisions to the contrary.

The decision of this Court in *Corn Products Co. v. Commissioner*, 350 U.S. 46, holds at p. 52, that the prefer-

ential tax treatment provided by Section 117 of the Internal Revenue Code of 1939, now Section 1221 of the 1954 Code, "applies to transactions in property which are *not* the normal source of business income." (Emphasis added.) The holdings of the courts below in the instant case are entirely consistent with that interpretation of the statute since respondent's sole reason for entering into the transaction in issue was to retain for himself as an attorney a normal source of his business income, namely legal fees from a valued client. (Petition, Appendix A, p. 14.)

The regulations themselves recognize that corporate stock is not always a capital asset. Regulation 1.165-5(b) states that:

> "If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss."

Both the regulations and the statute, Section 165, define the term "security" to include a share of stock in a corporation.

The Commissioner would also seek to develop a rule that stock should always be classified as a capital asset if it may be held by a taxpayer indefinitely. This is in the face of his own regulations which state explicitly that in determining whether property is a capital asset, the period for which it is held is immaterial. Regulation 1.1221-1.

The Commissioner's principal reason for seeking review really seems to be that it just isn't fair for the taxpayers in this and the *Waterman, Largen* case to be allowed a deduction for an ordinary loss because there is a possibility, created solely in the mind of the Commissioner, that if their respective stocks had appreciated and been sold at a profit, the taxpayers *might* have been successful in claiming capital gain treatment. This argument is based

totally on conjecture and should afford this Court no reason for finding that this case, decided correctly, based on its own uncontroverted facts, deserves review by this Court. In making this argument, the Commissioner chooses to ignore the instances when he has been successful in arguing that an asset acquired for business purposes and sold at a profit was not a capital asset and therefore that such profit was taxable as ordinary income. *Corn Products vs. Commissioner*, 350 U.S. 46; *Mansfield Journal Co. v. Commissioner*, 274 F.2d 284 (CCA 6, 1960); *Journal Co. v. U. S.*, 195 Fed. Supp. 434 (E.D. Wisc., 1961). Neither the results of these cases nor that of the instant case and the *Waterman, Largen* case indicate that any conflict, confusion or great and substantial problem exists requiring resolution by this Court. Each such case is decided by application of the sound, clear-cut and definitive doctrine set forth by this Court in *Corn Products* and applied consistently, reasonably and without confusion by the Courts to the particular fact circumstances before them. The fact that consistent application of a well-understood principle of law to varying sets of facts produces varying results in no way shows miscomprehension or misapplication of the principle but only illustrates that each such case must be decided on its own established facts. The Commissioner's argument appears even more fallacious when one considers that in all instances the taxpayer has the burden of proof in establishing the facts necessary to justify his reported treatment of a taxable event.

This plaintive appeal by the Commissioner also ignores the fact that the Code itself requires varying tax treatment for profits and losses in many instances. Section 1231 provides that gains on the sale of certain personal and real property used in a trade or business are capital

gains while losses on the sale of such property are ordinary losses. If the subject case had arisen because respondent had purchased a set of law books for use in his practice which became obsolete and therefore worthless to him and he had claimed an ordinary loss deduction, there is no doubt that his claim would never have been questioned. If on the other hand, the set of books was discovered to be a rare edition and was sold at a substantial profit, there is equally little doubt that the gain would be a capital one. Is there any difference in substance between that hypothetical situation and the instant case, where the courts below found as a fact that respondent purchased stock in a corporation to retain a client affording him substantial fees? Both the set of books and the capital stock were purchased for the purpose of being used in respondent's business. We submit that the Commissioner's belief that one situation is fair and the other not offers no sound reason for this Court to review an essentially factual determination by the courts below which found that respondent was entitled to an ordinary loss deduction.

Similarly, sale of certain qualified stock in a small business corporation (Section 1244 of the Code), or of stock in a small business investment company (Section 1242 of the Code), at a gain is taxed as a capital gain while sale of the same stock at a loss results in an ordinary loss deduction; while on the other hand, sale of certain stock in foreign corporations (Sections 1246, 1248 of the Code) at a gain may be wholly or partially taxed as ordinary income although sale at a loss of the same stock held for the same period of time by the identical taxpayer could be a capital loss.

We believe and suggest that if the Commissioner feels that the results of this case are unfair, the appropriate

place for him to seek relief is in the Congress of the United States, where he can request new legislation, rather than in the Supreme Court of the United States, where he now inappropriately seeks this Court's review of a decision based on a sound analysis of concurrent findings of facts by the two courts below (Petition, Appendix A, p. 14), applying well-settled principles of law previously enunciated by this Court in *Corn Products*, and applied consistently, correctly and without conflict by the lower federal courts (Petition, Appendix A, p. 15, cases cited p. 15 and p. 16).

As aptly stated by this Court in *Graver Tank & Manufacturing Company, Inc. v. Linde Air Products Co.*, 336 U.S. 271, at 275:

> "A court of law, such as this Court is, rather than a court for correction of errors in fact finding, cannot undertake to review concurrent findings of fact by two courts below in the absence of a very obvious and exceptional showing of error."

The question involved in this case is whether the stock of Richards Music, acquired under the circumstances and for the purposes determined by the courts below, constituted a capital asset in the hands of respondent. This is a factual issue of the type which this Court has consistently declined to review, *Layne & Bowler Corporation v. Western Well Works*, 261 U.S. 387; *Southern Power Co. v. No. Carolina Public Service Co.*, 263 U.S. 508; *Rudolph v. U. S.*, 370 U.S. 269; *Berenyi v. District Director, Immigration Service*, 385 U.S. 630.

The Commissioner's attempt to distinguish capital stock from other classes of property acquired for business purposes misses a very vital point. Although he cites the familiar principle that "the incidence of taxation depends upon the substance of a transaction," the Commissioner

does not recognize the fact that in the instant case and in similar cases such as *Booth Newspapers, Inc. v. U. S.*, 157 Ct. Cl. 886, 303 F.2d 916, and the cases discussed therein, the taxpayer is not acquiring stock for the purpose of owning stock, he is not in reality acquiring stock for its classic purpose, he is acquiring through the medium of stock a different asset or property, a thing needed in his regular business. In the instant case, the thing acquired was a continuing source of legal fees; in *Booth Newspapers*, it was a source of raw materials needed in the taxpayer's business. The Commissioner recognizes the above point in analyzing the *Corn Products* case (*Waterman, Largen* Petition, p. 11) yet he refuses or fails to recognize that there is no difference in substance between acquiring corn futures to insure a source of supply of corn and acquiring capital stock to insure a source of supply of corn. The taxpayer's intent and purpose and the end result sought to be achieved, not the means by which accomplished, is the "substance" which governs the tax treatment to be accorded the transaction.

The Commissioner approves the holdings in *Corn Products* and *Western Wine & Liquor Co. v. Commissioner*, 18 T.C. 1090, on the basis that they properly hold that a taxpayer which acquires one asset solely to obtain another will be deemed to have acquired the latter asset despite the form of the transaction. The Commissioner's attempt to distinguish the instant case from the decisions he approves truly exacts form over substance since the Courts below found that:

> "The only reasonable view that can be taken of Steadman's borrowing of $80,000 to acquire the shares here involved is that he did so to protect his position as general Counsel for Richards Music and the earnings necessarily flowing from such position. Such was the

holding of the Tax Court." (Petition, Appendix A, p. 14.)

Thus the Courts below found as a fact that Respondent acquired the capital stock in question only to acquire something else—a continuing source of business for his law practice, and their decisions herein are entirely in accord with, and are in fact required by, the very doctrine which the Commissioner approves.

The Commissioner's last appeal for review is based on the "burden" imposed upon him by the *Corn Products* doctrine coupled with a complaint that taxpayers have been too successful in winning cases involving the doctrine. This seems to offer no better reason for review than the inadequate ones which precede it. Many correct decisions impose a burden on taxpayers, both in particular and in general, which does not, of course, alone justify any taxpayer seeking a review of such decisions by this Court. It also seems rather doubtful that this Court would accept any taxpayer's case for review because of a claim that the Commissioner was winning too many cases involving a similar issue.

CONCLUSION.

The decision below was correct and no appropriate reasons have been cited nor do any exist for review of said decision by this Court. The Commissioner's Petition should be denied.

Respectfully submitted,

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